

Private Letter Ruling: Corporation designated a high impact business by the Department of Commerce and Community Affairs and which has some amount of payroll or property factor allocated to an enterprise zone qualifies to have its dividends subtracted in the computation of base income under IITA Section 203(a)(2)(J), (b)(2)(K), (c)(2)(O) or (d)(2)(M).

August 2, 2001

Dear:

This is in response to your letter dated July 20, 2001, in which you request a Private Letter Ruling on behalf of xxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxxx ("xxx"). Review of your request for a Private Letter Ruling disclosed that all information described in paragraphs 1 through 8 of subsection (b) of 86 Ill. Adm. Code Section 1200.110 appears to be contained in your request. The Private Letter Ruling will bind the Department only with respect to xxx for the issues presented in this ruling. Issuance of this ruling is conditioned upon the understanding that xxx and/or any related taxpayer(s) is not currently under audit or involved in litigation concerning the issues that are the subject of this ruling request.

The facts and analysis as you have presented them are as follows:

General Information

1. This request for a Private Letter Ruling ("PLR") is prepared by the undersigned who is acting as an agent for our client, xxx, pursuant to an original Form 2848, Power of Attorney, submitted herein.
2. This PLR is not requested with regard to hypothetical or alternative proposed transactions. The PLR is requested to determine the income tax consequences of the actual business practices of xxx.
3. xxx is not currently under audit by the Department or engaged in litigation with the Department in regard to this tax matter.
4. The Department has not previously ruled regarding this matter for xxx. Neither xxx nor xxxx has submitted the same or similar issues to the Department.
5. xxx requests that certain information be deleted from the PLR prior to dissemination to others. xxx requests that its name, address, location of its headquarters, description of products being sold and the name of its representative be deleted.
6. xxx knows of no authority contrary to the authorities referred to and cited below.

Statement of Material Facts

xxx is equally owned by xxxxxxxxxxxxxxxxxxxxxxxxxxxx ("xxxxxx") and xxxxxxxxxxxxxxxxxxxxxxxxxxxx, xxx. ("xxxxxx") through xxxxxxxxxxxxxxxxxxxxxxxxxxxx, xxxxxxxxxxxxxxxxxxxxxxxxxxxx ("xxxxxxxxxxxxxxxx"). xxx pays annual dividends to its two shareholders.

xxx is a rapidly growing company with total net sales in 1998, 1999, and 2000 of \$2,062,712,000, \$2,927,450,000 and \$3,538,898,000, respectively.

xxx is headquartered in xxxxxxxxxxxx, Illinois, in an area not located in a Foreign Trade Zone or Sub-Zone. The majority of xxxxx employees in Illinois are based at its xxxxxxxxxxxx [sic].

xxx received its HIB Certification for Designation from the Illinois Department of Commerce and Community Affairs in a letter dated xxxxxxxxxxx, 1999. The date of the Designation is xxxxxxxxxxx, 1998 and is effective for a period not to exceed twenty years.

xxx conducts numerous business operations within a Foreign Trade Sub-Zone, as described below. These activities are primarily conducted through a contract with xxxxxx at its locations at xxxxxxxxxxx, xxxxxxxxxxx and xxxxxxxxxxxxxxxxxxxxxxxxxxxx ("xxxxxxx") (collectively referred to herein as "xxxxxx locations") which have all been designated as Foreign Trade Sub-Zones. These facilities are not located within an Illinois Enterprise Zone.

Various phases of xxxxx non-clinical/pre-clinical research is conducted at xxxxxx. In addition, most of xxxxx packaging activities are conducted within the Foreign Trade Sub-Zones at xxxxxx locations and all of xxxxx products are shipped from a distribution center located within the Foreign Trade Sub-Zone at xxxxxxxxxxx. xxx considers itself to be a "virtual company" meaning that even though it is a full-service pharmaceutical company that partakes in research and development, packaging and the distribution of its products, these activities are largely performed by third parties. xxx would not have a business without these vital operations being conducted within the Foreign Trade Sub-Zones. The following is a description of xxx activities that have been conducted within the Foreign Trade Sub-Zones since the period of designation as a High Impact Business on xxxxxxxxxxx, 1998.

Research and development activities at xxxxxxxxxxx

In xxxxx 2001 projected budget, \$235 million is allocated to research and development ("R&D") activities. xxx projects to spend approximately \$52 million in 2001 on non-clinical/pre-clinical research, which includes activities such as metabolism, toxicology, and data management. Of this \$52 million for non-clinical/pre-clinical research, xxx will pay xxxxxx approximately \$22 million to conduct its research within the Foreign Trade Sub-Zone. The remainder of the projected budget is reserved for clinical research organizations ("CROs"), drug costs, R&D payroll, R&D overhead and additional development activities with third parties outside of Illinois.

xxx does not conduct research activities itself because it does not have laboratories. In addition, when xxx first entered the United States marketplace, xxxxxx had excess R&D and packaging capacity available at the time, making xxxxxx an excellent choice as a third-party contractor. Many of xxxxx employees are former employees of xxxxxx and are familiar with xxxxxxxx R&D methodology, thereby providing xxx with a level of comfort concerning xxxxxxxx competencies.

xxx uses xxxxxx resources within the Foreign Trade Sub-Zone controlled by xxx personnel to help develop its products. Some xxxxxx employees work solely on developing xxx compounds. Over the last five years, xxx has five to ten project managers which oversee the development of compounds at xxxxxx locations within the Foreign Trade Sub-Zone. The frequency that a

project manager would work at xxxxxx locations depends on both the project manager and the compound being developed.

The xxxxxx team members keep track of their time spent working on xxx compounds which is billed to xxx. xxx receives a monthly invoice from xxxxxx with an itemized list of compounds xxxxxx worked on and the amount of time spent, by division, on each compound.

xxx receives many bulk substances from Japan which are processed and formulated into the drug products as part of the R&D function. The bulk substances from Japan are shipped directly to the Foreign Trade Sub-Zone at xxxxxx locations. As you may be aware, the pharmaceutical industry is heavily regulated by the Food and Drug Administration ("FDA"), Bureau of Alcohol Tobacco and Firearms ("BATF"), and the Drug Enforcement Agency ("DEA"). xxx does not have the properly controlled facilities, as is required by the aforementioned regulatory bodies, to receive or warehouse these substances. Therefore, these substances must be shipped directly to xxxxxx, which is an appropriately licensed facility and designated a Foreign Trade Sub-Zone.

Approximately 10 percent of the pharmaceutical R&D work conducted at xxxxxx within the Foreign Trade Zone is for xxx. This percentage is low in comparison to the R&D work done on xxxxxxxx behalf because xxxxxxxx R&D requires more pre-clinical, discovery type R&D including toxicology, pharmacology and metabolism work. Most of xxxxx R&D activities focus on the non-clinical development of existing compounds. xxx obtains compounds through licenses with third parties and conducts only limited discovery research. Conversely, xxxxxx has a much larger discovery program and develops many of its compounds internally.

Manufacturing activities

xxx currently has three products on the market in the United States, xxxxxx, xxxxxxxx and xxxxxxxx. These products are manufactured by xxxxxx and shipped initially to xxxxxxxx Foreign Trade Sub-Zone location where the items are packaged or shipped to third party packagers as described below. Any future compounds xxx hopes to develop into products are still in development. As such, xxx does not currently have manufacturing operations.

Packaging activities at xxxxxxxxxxxx and xxxxxxxxxxxxxx

xxx has entered into a packaging agreement with xxxxxx whereby xxxxxxxx is packaged at xxxxxxxxxxxxxx and xxxxxx at xxxxxxxxxxxxxx. xxxxxxxx is a combination of three products which must be packaged in a dedicated facility to avoid cross-contamination and resistance issues. Since xxxxxx does not have the appropriate facilities, xxx has contracted with a third party packager, xxxxxxxxxxxxxxxxxxxxxxxxxx ("xxx") to package xxxxxxxx. xxx does not package any products because it does not have packaging facilities.

xxx receives approximately 500 manufactured lots of xxxxxxxx (15mg and 30mg strengths) a year from xxxxxx, with approximately 1.75 million capsules in a 30mg lot and 3.4 million capsules in a 15mg lot. On average, xxx receives about nine lots a week.

xxx receives approximately 171 manufactured lots of xxxxxx a year from xxxxxx. On average, xxx receives about 3 lots a week.

xxxxxx ships the capsules to xxx via Japan Airlines to O'Hare Airport, where it clears customs and a trucking company brings the capsules directly to xxxxxx locations. Once the capsules reach xxxxxx locations, xxxxxx employees test the capsules. The testing takes approximately three days. The capsules could then be put into packaging production, however, xxxxxx currently has a five week work-in-process backlog, so the capsules are put into available inventory at xxxxxx locations. After the capsules are placed in inventory, some of the xxxxxxxx capsules are then shipped to xxx for inclusion in xxxxxxxx. xxxxxx goal is to deliver the finished goods to its customers within one month of receipt of the capsules from Japan, which would include testing, packaging, closing out documentation and delivering the finished product to the warehouse.

xxxxxx has ten automated production lines for packaging at xxxxxxxxxxxx, five of which package xxxxxxxx for xxx. While no production line is completely dedicated to packaging xxxxx products, of the five production lines which package xxxxxxxx, 77%, 60%, 42%, 40% and 78% of the time is dedicated to packaging xxxxxxxx, based on current production records. On certain occasions, xxx has requested that xxxxxx stop packaging its own products to package xxxxx products due to customer demand.

xxxxx materials manager works at xxxxxx locations approximately twice a week to meet with xxxxxxxx materials management, scheduling and planning personnel. xxxxx materials manager also monitors inventory levels and prioritizes deliveries, along with meeting with finance, planning, and engineering groups. xxxxx materials manager works at xxxxxx locations to oversee the packaging of xxxxxx about twice a month.

xxxxxx bills xxx for packaging costs based on a standard cost. Any equipment xxxxxx is required to purchase to package xxx products is built into the standard cost. However, if xxx were to change its packaging design to eliminate the need for equipment specifically purchased to package xxx products, then xxx would be required to pay xxxxxx for the cost of the equipment not yet amortized.

Distribution center at xxxxxxxxxxxx

All of xxxxx finished goods inventory is located at xxxxxxxx distribution center in xxxxxxxxxxxx. Once xxxxxx and xxxxxxxx are packaged by xxxxxx and xxxxxxxx is packaged by xxx, they are sent to the distribution center. In addition, xxx has a new product not yet for sale in the United States that will be packaged by a third party and warehoused at the xxxxxxxxxxxx distribution center. xxx coordinates the transportation of the products to the xxxxxxxxxxxx distribution center with xxxxxxxx transportation group.

Orders for xxx products are received electronically by xxxxx customer services group and transferred to the distribution center. Product is then shipped directly to xxxxx customers. The quantity of samples produced for distribution by sales representatives is determined by xxx Marketing. Upon being packaged, the samples are transferred to the distribution center and then shipped from the distribution center to the sales representatives. xxxxxx controls all inventory for xxx, with those associated costs built into the packaging standard cost.

SG&A activities at xxxxxx locations

xxx has a contract with xxxxxx to provide many selling, general and administrative ("SG&A") activities for xxx. In 2000, xxx purchased \$11 million of SG&A services from xxxxxx. The compensation paid to xxxxxx for some departments such as the tax, payroll and the administrative departments, is agreed upon at the beginning of the year. xxxxxx passes other SG&A costs through to xxx. The major categories by cost are for floor charges, MIS charges, corporate legal fees, marketing promotion and telecommunications. These categories comprise approximately 75% of the services xxx purchased from xxxxxx. xxxxxx performs these services at its xxxxxxxxxxxx facility which is designated as a Foreign Trade Sub-Zone.

xxx has a wholly-owned subsidiary, xxx Finance, which purchases and collects trade receivables. The subsidiary has three employees whose full-time work location is at xxxxxxxx. xxxxxxxxxxxx has equipment, furniture, and fixtures located at xxxxxxxx, as well as a lease with xxxxxx for office space. As stated earlier, xxxxxxxx is designated as being within a Foreign Trade Sub-Zone.

Rulings Requested

1. xxx respectfully requests a binding PLR from the Department confirming that all of xxxxx dividends paid to its shareholders, xxxxxx and xxxxxxxxxxxxxxxx, would qualify for the subtraction modification codified in IITA §203(b)(2)(L) as dividends paid by a corporation that conducts business operations in a federally designated Foreign Trade Sub-Zone and that is designated a High Impact Business located in Illinois.
2. xxxxxx and xxxxxxxxxxxxxxxx are eligible for the subtraction modification for all tax years ending after September 1, 1998.

Relevant Authorities

The Illinois Income Tax Act ("IITA") defines base income of a corporation as the taxpayer's taxable income for the taxable year as modified. (35 ILCS 5/203(b)(1)). One subtraction modification to arrive at base income is codified in IITA §203(b)(2)(L) and reads as follows:

An amount equal to those dividends included in such total that were paid by a corporation that conducts business operations in a federally designated Foreign Trade Zone or Sub-Zone and that is designated a High Impact Business located in Illinois; provided that dividends eligible for the deduction provided in subparagraph (K) of paragraph 2 of this subsection shall not be eligible for the deduction provided under this subparagraph (L). (35 ILCS 5/203(b)(2)(L)).

The above statute provides an exception to the HIB dividend subtraction modification for dividends eligible for deduction under subparagraph (K). Subparagraph (K) provides a subtraction modification for dividends that were paid by a corporation conducting substantially all of it [sic] business operations in an Illinois Enterprise Zone. (35 ILCS 5/203(b)(2)(K)). Therefore, dividends paid by a corporation that meet both the Enterprise Zone requirements in (K) and the HIB operating in a Foreign Trade Zone requirements in (L) may only be subtracted under the Enterprise Zone statute.

HIB Requirements

A business can be designated by DCCA as a HIB if it is not located in an Enterprise Zone and is found by DCCA to promote the growth and expansion of the private sector through a large scale investment and development project as defined by law.

The business must make a minimum eligible investment of \$12 million which will be placed in service in qualified property in Illinois and is intended to create 500 full-time equivalent jobs at a designated location in Illinois or make a minimum eligible investment of \$30 million which will be placed in service in qualified property in Illinois and is intended to retain 1,500 full-time equivalent jobs at a designated location(s) in Illinois. (20 ILCS 655/5.5(a)(3)). The business must also certify in writing that the investment would not be placed in service in qualified property and the job creation or job retention would not occur without the tax credits and exemptions provided. (Id.).

xxx received its HIB Certification for Designation from the Department of Commerce and Community Affairs in a letter dated xxxxxxxxx, 1999. The date of the Designation is xxxxxxxxx x, 1998 and is effective for a period not to exceed twenty years. xxx therefore meets the requirement for the dividend subtraction modification that the corporation paying the dividend is designated a HIB located in Illinois.

Business Operations in a Foreign Trade Sub-Zone

The statute does not contain any language specifying the level of operations to be conducted in the Foreign Trade Zone or Sub-Zone. Nor has the Department provided any guidance as to the required level of operations to be conducted within a Foreign Trade Zone or Sub-Zone. The Department has not published any Private Letter Rulings, General Information Letters or Administrative Hearings addressing this topic, nor has the issue arisen in any published Illinois court case.

The HIB dividend subtraction modification does not specify a minimum threshold amount of business operations required to be located in a Foreign Trade Zone or Sub-Zone. A large portion of xxxxx non-clinical/pre-clinical research is conducted in a Foreign Trade Sub-Zone and supervised by xxx personnel. Drug capsules of certain compounds are shipped from Japan into a licensed facility located in a Foreign Trade Sub-Zone. A majority of xxxxx products are packaged in a Foreign Trade Sub-Zone, with all finished goods inventory stored and shipped from a distribution center located in a Foreign Trade Sub-Zone. Many other general and administrative services are performed by xxxxx for xxx in a Foreign Trade Sub-Zone, in addition, all of xxxxxxxxxxxxxx employees' physical work site is located in a Foreign Trade Sub-Zone. The activities located in a Foreign Trade Sub-Zone comprise a vital part of xxxxx business operations such that without these operations xxx would not have a business. xxx therefore meets the requirement for the dividend subtraction modification that the corporation paying the dividend is conducting business operations in a Foreign Trade Sub-Zone.

Conclusion

xxx has therefore concluded that the dividends paid to its shareholders, xxxxxx and xxxxxx xxxxxxxx, would qualify for the subtraction modification codified in IITA §203(b)(2)(L) since xxx is designated a HIB and is conducting vital business operations in a Foreign Trade Sub-Zone.

RULING

Applicable Law

With respect to individuals, corporations, and trusts and estates, sections 203(a)(2)(J), 203(b)(2)(K), and 203(c)(2)(M) of the Illinois Income Tax Act ("the IITA"; 35 ILCS 5/101 *et seq.*) provide, respectively, the following subtraction modification in the computation of base income:

An amount equal to those dividends included in such total which were paid by a corporation which conducts business operations in an Enterprise Zone or zones created under the Illinois Enterprise Zone Act and conducts substantially all of its operations in an Enterprise Zone or zones[.]

Department of Revenue Regulations section 100.2480(b) establishes the test to determine whether a corporation conducts "substantially all" of its operations in an Enterprise Zone or zones, as follows:

A corporation conducts substantially all of its business within an Enterprise Zone when 95% or more of its total business activity during a taxable year is operated within an Enterprise Zone. For the purpose of this Section, business activity within an Enterprise Zone shall be measured by means of the factors ordinarily applicable to the corporation under subsection (a), (b), (c), or (d) of IITA Section 304 except that, in the case of a corporation ordinarily required to apportion business income by means of the 3-factor formula of property, payroll and sales specified in subsection (a) of Section 304, such corporation shall not use the sales factor in the computation. In measuring the business activity of a corporation within an Enterprise Zone, the apportionment factors of that corporation shall be determined without regard to the factors or business activity of any other corporation and, in the case of a corporation engaged in a unitary business with any other person, the apportionment factors of that corporation shall be determined as if it were not engaged in a unitary business with such other person.

Regarding a corporation ordinarily required to apportion business income by means of the three-factor formula of IITA section 304(a), section 100.2480(b)(1) continues as follows:

3-Factor Corporations: A corporation using property, payroll and sales to apportion business income to Illinois under subsection (a) of Section 304 shall compare the corporation's property and payroll within an Enterprise Zone to the corporation's property and payroll everywhere. The result of the property and payroll factor computations shall be divided by 2 (by one if either the property or payroll factor has a denominator of zero). If the amount so computed is 95% or greater, the dividends paid by the corporation shall qualify for this subtraction. In the case where a corporation does not have any payroll or property within an Enterprise Zone, the corporation is not conducting any of its business operations within an Enterprise Zone for the purpose of this Section.

IITA section 203(b)(2)(L) provides corporations a similar subtraction modification as that allowed under section 203(b)(2)(K). Section 203(b)(2)(L) states:

An amount equal to those dividends included in such total that were paid by a corporation that conducts business operations in a federally designated Foreign Trade Zone or Sub-Zone and that is designated a High Impact Business located in Illinois; provided that dividends eligible for the deduction provided in subparagraph (K) of paragraph 2 of this subsection [regarding dividends paid by a corporation conducting substantially all of its operations in an Illinois Enterprise Zone or zones] shall not be eligible for the deduction provided under this subparagraph (L)[.]

Although regulations have not been promulgated under IITA section 203(b)(2)(L), the provision is similar to the subtraction modification allowed under section 203(b)(2)(K). Thus, to the extent not inconsistent with the language of section 203(b)(2)(L), the subtraction modification provided therein will be applied according to the rules at Regulations section 100.2480, regarding dividends paid by a corporation that conducts substantially all of its business operations in an Illinois Enterprise Zone. Consistent with section 203(b)(2)(L), then, Regulations section 100.2480 shall be applied with the following modifications. First, the corporation must be designated a High Impact Business located in Illinois. Second, the corporation must conduct business operations in a federally designated Foreign Trade Zone or Sub-Zone. Third, because section 203(b)(2)(L) requires merely that business operations be conducted in a federally designated Foreign Trade Zone or Sub-Zone, rather than “substantially all” of such operations as required under section 203(b)(2)(K), Regulations section 100.2480(b) shall be applied by substituting the term “greater than 0%” in place of the term “95% or more.” Finally, dividends paid by such corporation must not be eligible for the subtraction modification provided by IITA section 203(b)(2)(K).

Accordingly, a corporation designated a High Impact Business in Illinois and that apportions business income to Illinois under subsection (a) of IITA section 304 must compare its property and payroll within a federally designated Foreign Trade Zone or Sub-Zone to the corporation's property and payroll everywhere. The result of the property and payroll factor computations is then divided by 2 (by 1 if either factor has a denominator of 0). If the amount so computed is greater than 0%, and the dividends paid are not eligible for the subtraction modification under section 203(b)(2)(K), the dividends paid by the corporation will qualify for the subtraction modification provided by section 203(b)(2)(L).

Analysis

In the instant case, you have indicated that xxx has been designated a High Impact Business located in Illinois effective xxxxxxxxxxxx, 1998. In addition, it appears that dividends paid by xxx would not be eligible for the subtraction modification under IITA section 203(b)(2)(K), regarding a corporation that conducts substantially all its operations in an Illinois Enterprise Zone. Therefore, dividends paid by xxx will qualify for the subtraction modification under section 203(b)(2)(L) provided that it conducts business operations in a federally designated Foreign Trade Sub-Zone.

Applying the rules of Regulations section 100.2480 in the manner indicated above, neither the activities of xxxxxx nor xxxxxxxxxxxx may be taken into account in determining whether xxx conducts business operations in a federally designated Foreign Trade Sub-Zone. Rather, only the property and

payroll factors of xxx may be considered. You have indicated that xxx maintains significant quantities of inventory at xxxxxxxx distribution center in xxxxxxxxxxxx, a federally designated Foreign Trade Sub-Zone. Therefore, xxx has property includable in the numerator of the federally designated Foreign Trade Sub-Zone property factor, resulting in a factor greater than 0%. Accordingly, xxx conducts business operations in a federally designated Foreign Trade Zone or Sub-Zone for purposes of the subtraction modification under IITA section 203(b)(2)(L).

Conclusion

In accordance with the above analysis, dividends paid by xxx on or after xxxxxxxxxxxx, 1998 are eligible for the subtraction modification under IITA section 203(b)(2)(L). In addition, as shareholders of xxx, xxxxxx and xxxxxxxxxxxxxxxxxx will be allowed this subtraction modification for distributions from xxx otherwise eligible under the rules of Regulations section 100.2480.

The facts upon which this ruling is based are subject to review by the Department during the course of any audit, investigation or hearing. This ruling shall bind the Department only if the material facts as recited in this ruling are correct and complete. This ruling will cease to bind the Department if there is a pertinent change in statutory law, case law, rules or in the material facts recited in this ruling.

Very Truly Yours,

Brian L. Stocker
Staff Attorney (Income Tax)